TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITEE MEETING

SUBJECT: Update on State Legislation ITEM NUMBER: 7

ATTACHMENT(S): 3

ACTION: X MEETING DATE: June 3, 1998

INFORMATION: ______ PRESENTER: Ms. DuCray-Morrill

State Legislation

Summary

Staff has prepared the attached analyses and recommended positions on the following measures for the Board's consideration:

Bill Number	Author	Subject
AB-1744	Knox, Honda & Perata	Tobacco Investments
SB-1433	Hayden	Tobacco Investments

Status of Board Sponsored Legislation for 1998

Ms. DuCray-Morrill will provide a verbal update at the meeting on the current status of Board-sponsored legislation.

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Assembly Bill 1744,	**Assembly Members Knox, Honda & Perata**	(Amended 5/7/98)
Position:	**Oppose**	
Proponents:	**AFSCME, American Lung Association, California Firefighters Association, CalPIRG, CTA, Phil Angelides for Treasurer**	
Opponents:	**Cal-Tax, PERS The Smokeless Tobacco Council, The Tobacco Institute**	

SUMMARY

This bill would: 1) prohibit new or additional investments by the State Teachers' Retirement System (STRS) and the Public Employees' Retirement System (PERS) in tobacco companies on or after January 1, 1999; 2) require phased divestment of one third of current holdings each year beginning January 1, 2000, and continuing until January 1, 2002; 3) require the Board to make specified investment valuations at specified intervals; declare that specified results of such valuations be considered as a normal cost deficit pursuant to Section 22955 (Elder Full Funding); and 4) require both STRS and PERS to report to the Legislature on or after January 1, 2002 regarding the effect of the divestiture on employer contribution rates. The bill provides for indemnification for Board members and their agents and employees in the event of lawsuit.

HISTORY

See prior analysis.

CURRENT PRACTICE

As of March 31, 1998 STRS has investments in 26 tobacco or tobacco related companies. The combined market value of these investments for that period is $555,472,194. This represents 0.960% of the total value of the domestic and international equities in the STRS portfolio.

DISCUSSION

This bill declares that congressional and court actions against tobacco companies as well as restrictions on their business practices have materially affected their stock holdings and that the investment of PERS and STRS trust funds in tobacco stocks and bonds is fiscally imprudent.

The bill would indemnify the members of the governing board, state officers and employees, and investment managers for any losses associated with the implementation of the bill.

Historically, the Board has opposed divestiture legislation due to conflicts with the Board's fiduciary responsibility to invest in a prudent manner for the sole and exclusive benefit of the members and beneficiaries of STRS. Prudent fiduciary responsibilities require that the Board invest in the widest possible investment universe. Reducing that universe, no matter by what amount, impairs the Board's ability to uphold that responsibility.

At the March Investment Committee meeting the Board directed staff to obtain an analysis from an external third party to provide an independent assessment of the impact the divestiture of tobacco holdings would have on the TRF. The firm BARRA ROGERSCASEY (BARRA) was retained to conduct the assessment.

The BARRA report outlines previous tobacco research conducted by BARRA, comments on the McCain Bill and addresses the analysis of the STRS Equity Portfolio.

Their analysis of the STRS Equity Portfolio focused on the elements of return and risk. BARRA looked at 55 months of STRS equity investment history and isolated the effects of tobacco industry exposure on both the U.S. and non-U.S. equity portfolios. The analysis yielded the cost figures from tobacco divestiture as well as divestiture's effect on the volatility or "riskiness" of the fund. The analysis contains detailed estimates of the dollar transaction cost to STRS if the tobacco holdings currently in the portfolio were divested and the proceeds invested in non-tobacco stocks.

The report concludes that based on the BARRA study of the S&P index and STRS portfolio analysis, tobacco divestiture does not increase return and decrease risk. Rather, divestiture increases active risk. Both the STRS U.S. and non-U.S. equity portfolios outperformed their ex-tobacco counterparts on an annualized basis. The absolute annual return differential, 7 basis points (U.S.) and 4 basis points (non-U.S.), translate into annual investment losses of $21.7 million and $6.4 million, respectively, when applied to the large STRS portfolio, and $8.1 million in lost opportunity costs.

The report further concludes that tobacco divestiture does not stand up as an investment decision. It does not reduce risk in the typical pension fund context or in the specific example of the STRS fund.

The May 7 amendments make several changes:

1. Redefines "tobacco company" from a business entity involved in the production of cigarettes or tobacco-related products to one that makes more than 10 percent of its gross revenue from tobacco products or has 10 percent of its personnel involved in tobacco products or has more than 10 percent of its business activity in tobacco products.

   This is a significant amendment. The definition might now be interpreted to include distributors, publishers and advertising companies. Amending the bill to expand beyond those companies that produce cigarettes or tobacco-related products will increase the universe of potential "covered companies" thereby increasing the fiscal impact of divestment. The research necessary to define such companies would be expensive and cumbersome, especially when it is not uniformly disclosed in financial reports from foreign companies.

   The expanded definition of tobacco companies would likely increase staffing requirements for STRS as not only would current holdings need to be evaluated, the restriction would be on-going and all future purchases would also require evaluation against this definition. Likewise, there could also be increased investment management costs to the fund, as the external managers would also be subject to this definition.

2. The amendments attempt to provide a benchmark (formula) to calculate losses, if any, suffered by the Teachers' Retirement Fund from divestment as proposed in this bill. Essentially, the amendments would require STRS to value the portfolio with all tobacco company investments as of 1/1/2000 and track that portfolio over a 15-year period as if they remained in the portfolio. The valuation shall include all dividends which would have been earned and reinvested for both the calculation of the value of the Standard and Poors (S&P) 500 Index and the previously held tobacco company investments.

3. The stated formula will not measure the losses or opportunity costs suffered by international/active managers. It will not consider the increased risk expected to be experienced if divestiture is required. The BARRA report stated that the ex-tobacco portfolio increased active risk by 0.13% or 13 basis points on the domestic portfolio.

4. The amendment appears to extend the definition of normal cost deficit contained within the Elder Full Funding statutes to include those losses, if any, identified through the formula provided in the bill. Elder Full Funding provides for a General Fund transfer to the Fund of any normal cost deficit. The application of the formula to determine investment losses as a result of this bill, if any, and the process by which any normal cost deficit would be recovered through Elder Full Funding are not clearly described in the bill, however. Following are a number of questions staff have identified:

   a) The Board is to determine the value of the tobacco investment on January 1, 2000 the same day it is to commence divestment of one third of its tobacco investment. The bill does not specify if that valuation should occur prior to the commencement of divestment or after it has begun.

   b) Section 16648(d) has the Board taking an action on January 1, 2014 that would utilize data to be gathered on January 1, 2015. The date of that action should be changed to January 1, 2015.

   c) The timelines for recovering from a loss are unclear in the bill. If a loss is determined as of January 1, 2010, would the next Elder Full Funding calculation, October 1, 2010, include that increase to the normal cost deficit? What would happen if the needed increase equated to more than a 0.25% of prior year payroll?

   Would the result of the second comparison, January 1, 2015, be combined with the loss identified January 1, 2010 and the normal cost deficit be adjusted accordingly with an increase or decrease in the Elder Full Funding transfer? Or, would STRS have to wait until the final valuation at January 1, 2015 to determine if there had been a loss over time which would increase the normal cost deficit? In that instance, Elder Full Funding would not be recalculated until October 1, 2015.

The only assured result of this bill, as amended, is a report to the legislature. Elder Full Funding provides a maximum of 4.3 percent of prior year payroll until the unfunded obligation is deemed to have been eliminated.

The bill should provide indemnification to make the Fund whole, regardless of the status of liability and require a pay as you go reimbursement, rather than waiting 10 or 15 years. Reimbursement for any losses should not be tied to Elder Full Funding but continuously appropriated.

Staff have identified a number of amendments required to clarify the author's intent:

1. STRS would prefer the terminology "investments" to describe the portfolio components, rather than "stocks and shares".

2. The international and active portfolios need to have separate benchmarks for valuation.

3. In order to perform the required comparisons between the stocks and shares and the S&P 500 Index, STRS may be required to run a phantom portfolio.

4. The employer contribution rates to STRS are set in statute and therefore would not be effected by divestiture. What could be effected would be an unfunded actuarial obligation, were the investment return to be less than the actuarial assumed rate.

5. An additional concern with the loss formula is the link between the valuation and the contribution (state) based on the normal cost deficit. First of all, there appears to be a mistake in the writing: "If the sum of the two valuations is that the value of the stocks and shares is GREATER than the value of the Standard and Poors 500 Index, then this amount shall be considered as a normal cost deficit in the State Teachers' Retirement Fund pursuant to Section 22955 of the Education Code. If the sum of the valuations is that the value of the Standard and Poors 500 Index is GREATER than the stocks and shares, then it shall be considered to have no effect on that normal cost deficit." It appears that one of these "greaters" should be a "lesser." Finally, it does not seem that this gives the Fund true indemnification. The preparation of all these reports will only result in a report to the Legislature. The Legislature does not seem to have any affirmative duty to reimburse the Fund for any losses in this process.

FISCAL IMPACT

Program - Annual investment losses of $28.1 million and a one time cost of $8.1 million in commission costs, or 2.15% of the value of STRS tobacco holdings to divest in tobacco and tobacco related investments.

Administrative - Additional staffing could be required to continually monitor potential purchases as well as possibly run a phantom portfolio in order to fulfill the requirements of the bill.

POSITION

Oppose - The Board opposes AB-1744 based upon the report of the independent consultant, BARRA ROGERSCASEY, and the fiduciary responsibility of the Board.

Senate Bill 1433,	**Senator Hayden**	(Amended 5/20/98)
Position:	**Oppose**	
Proponents:	**AFSCME, American Cancer Society, American Heart Assoc., American Lung Assoc., California Professional Firefighters Assoc., Cal-PIRG, Phil Angelides for Treasurer**	
Opponents:	**CRTA (unless amended), PERS, The Tobacco Institute**	

SUMMARY

This bill would: 1) prohibit new or additional investments by the State Teachers' Retirement Fund and the Public Employees' Retirement Fund in tobacco companies on and after January 1, 1999; and 2) require STRS and PERS to report to the Legislature annually on and after January 1, 2003 regarding the effect on employer contribution rates of the prohibition against new or additional tobacco company investments. The May 20, 1998 amendments removed the requirement for a phased divestment and expanded the definition of "tobacco company".

HISTORY

See prior analysis.

CURRENT PRACTICE

As of March 31, 1998 STRS has investments in 26 tobacco or tobacco related companies. The combined market value of these investments for that period is $555,472,194. This represents 0.960% of the total value of the domestic and international equities in the STRS portfolio.

DISCUSSION

This bill declares that the state spends approximately $630 million treating tobacco related illnesses and another $50 million on anti-smoking education while the Public Employees' Retirement Fund holds $989,097,528 in tobacco company investments. In addition, due to recent litigation, the value of CalPERS tobacco-related equity holdings have declined and product liability litigation introduces an unreasonably high element of risk to state pension funds.

The employer contribution rates to STRS are set in statute and therefore would not be effected by divestiture.

At the March Investment Committee meeting the Board directed staff to obtain an analysis from an external third party to provide an independent assessment of the impact the divestiture of tobacco holdings would have on the fund. The firm BARRA ROGERSCASEY (BARRA) was retained to conduct the assessment.

The report concludes that based on the BARRA S&P index study and STRS portfolio analysis tobacco divestiture does not increase return and decrease risk. Divestiture increased active risk. Both the STRS U.S. and non-U.S. equity portfolios outperformed their ex-tobacco counterparts on an annualized basis. The absolute annual return differential, 7 basis points and 4 basis points, respectively, translate into annual investment losses of $21.7 million and $6.4 million, respectively, when applied to the large STRS portfolio. Were STRS to divest the fund's tobacco holdings and reinvest the proceeds in non-tobacco stocks, the estimated one-time costs would cost $8.1 million.

The report further concludes that tobacco divestiture does not stand up as an investment decision. It does not reduce risk in the typical pension fund context or in the specific example of the STRS fund.

The May 20**,** 1998 amendment redefines "tobacco company" from a business entity involved in the production of cigarettes or tobacco-related products to one that makes more than 10 percent of its gross revenue from tobacco products or has 10 percent of its personnel involved in tobacco products or has more than 10 percent of its business activity in tobacco products.

This is a significant amendment. The definition might now be interpreted to include distributors, publishers and advertising companies. Amending the bill to expand beyond those companies that produce cigarettes or tobacco-related products will increase the universe of potential "covered companies" thereby increasing the fiscal impact of divestment. The research necessary to define such companies would be expensive and cumbersome, especially when it is not uniformly disclosed in financial reports from foreign companies.

The expanded definition of tobacco companies would likely increase staffing requirements for STRS as not only would current holdings need to be evaluated, the restriction would be on-going and all future purchases would also require evaluation against this definition. Likewise, there could also be increased investment management costs to the fund, as the external managers would also be subject to this definition.

FISCAL IMPACT

Program - Unknown, although the potential losses from divestment are no longer an issue, there would still be significant lost opportunity costs associated with the restricted range of future investments.

Administrative - Unknown costs associated with maintaining a phantom portfolio to conform to the requirements of the annual report to the legislature, as well as monitoring all future investments against the definition of “tobacco company”.

POSITION

Oppose - The Board opposes SB-1433 based upon the report of the independent consultant, BARRA ROGERSCASEY, and the fiduciary responsibility of the Board.

STATE TEACHERS' RETIREMENT SYSTEM
LEGISLATIVE SUMMARY - INVESTMENT COMMITTEE
1997-98 Regular Session - May 21, 1998

BILL NO. >>> STATUS <<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<

CA AB 1744 AUTHOR: Knox, Honda & Perata
TITLE: Tobacco Investments
AMENDED: 05/07/98
LOCATION: Assembly Appropriation
POSITION: *Oppose

SUMMARY: Would: 1) prohibit new or additional investments by the TRF and the PERF in tobacco companies on and after January 1, 1999; 2) require phased divestment of one-third of current holdings each year beginning January 1, 2000, and continuing until January 1, 2002; 3) require the Board to make specified investment valuations at specified intervals; declare that specified results of such valuations be considered as a normal cost deficit pursuant to Section 22955 (Elder Full Funding); and 4) require both STRS and PERS to report to the Legislature on or after January 1, 2002 regarding the effect of the divestiture on employer contribution rates. The bill provides for indemnification for Board members and their agents and employees in the event of lawsuit.

COST: Program - Annual investment losses of $28.1 million and a one time cost of $8.1 million in lost commissions, or 2.15% of the value of STRS tobacco holdings to divest in tobacco and related investments
Administrative - Possible $9 million in commissions, or about $300,000 each of the three years, to divest in tobacco and related investments

P - Authors (Sponsors), AFSCME, ALA, CPFFA, CalPIRG, CTA, Phil Angelides for Treasurer
O - Cal-Tax, PERS, STRS, Other interested parties

STATE TEACHERS' RETIREMENT SYSTEM
LEGISLATIVE SUMMARY - INVESTMENT COMMITTEE
1997-98 Regular Session - May 21, 1998

BILL NO. >>> STATUS <<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<<

CA SB 1433 AUTHOR: Hayden
TITLE: Tobacco Investments
AMENDED: 05/20/98
LOCATION: Senate Appropriations
POSITION: *Oppose

SUMMARY: Would: 1) prohibit new or additional investments by the TRF and the PERF in tobacco companies on and after January 1, 1999; 2) require STRS and PERS to report to the Legislature annually on and after January 1, 2003 regarding the effect on employer contribution rates of the prohibition against new or additional tobacco company investments. The May 20, 1998 amendments remove the requirement for a phased divestment and expanded the definition of "tobacco company".

COST: Program - Unknown, although the potential losses from divestment are no longer an issue, there would still be significant lost opportunity costs associated with the restricted definition of "tobacco company".
Administrative - Unknown, but likely significant costs associated with maintaining a phantom portfolio to conform to the requirements of the annual report to the legislature, as well as monitoring all future investments against the definition of "tobacco company".

P - Author (Sponsor), AFSCME, ACS, AHA, ALA, CPFFA, CalPIRG, Phil Angelides for Treasurer
O - Cal-Tax, CRTA (Unless amended), PERS, The Tobacco Institute

L E G E N D OF ABBREVIATIONS

P = PROPONENTS O = OPPONENTS

ABBREVIATION	ORGANIZATION
AALA	Associated Administrators of Los Angeles
ACCCA	Association of California Community College Administrators
ACLU	American Civil Liberties Union
ACS	American Cancer Society
ACSA	Association of California School Administrators
AFSCME	American Association of State, County and Municipal Employees
AFT	American Federation of Teachers
AGENCY	State and Consumer Services Agency
AHA	American Heart Association
ALA	American Lung Association
ALADS	Association for Los Angeles Deputy Sheriffs
ART	Association of Retired Teachers
AGO	Attorney General's Office
BOE	Board of Equalization
BOG	Board of Governors, California Community Colleges
Cal-Tax	California Taxpayers Association
CalPIRG	California Public Interest Group
CASBO	California Association of School Business Officers
CCA	Community College Association
CCAE	California Council for Adult Education
CFA	California Faculty Association
CFT	California Federation of Teachers
CHA	California Heart Association
CPOA	California Peace Officers' Association
CPCA	California Police Chiefs' Association
CPFFA	California Professional Firefighters Association
CRTA	California Retired Teachers Association
CSAC	California Association of Counties
CSBA	California School Boards Association
CSEA	California School Employees Association
CSL	California Senior Legislature
CSU	California State University
CTA	California Teachers Association
DOE	Department of Education
DOF	Department of Finance
DGS	Department of General Services
DPA	Department of Personnel Administration
FACCC	Faculty Association of California Community Colleges
FCPHE	Faculty Coalition for Public Higher Education

L E G E N D OF ABBREVIATIONS

P = PROPONENTS   O = OPPONENTS

ABBREVIATION	**ORGANIZATION**
FTB	Franchise Tax Board
FSC	Free Speech Coalition
LADSA	Los Angeles Deputy Sheriffs' Association
LAUSD	Los Angeles Unified School District
MPAA	Motion Picture Association of America, Inc.
OCDE	Orange County Department of Education
PRF	Public Employees Retirement Fund
PERS	Public Employees Retirement System
RPEA	Retired Public Employees Association
RIAA	Recording Industry Association of America
SACRS	State Association of County Retirement Systems
SCDSA	Sacramento County Deputy Sheriffs Association
SBMA	Supplemental Benefit Maintenance Account
SDCOE	San Diego County Office of Education
SEIU	Service Employees International Union
SLC	State Lands Commission
SSC	School Services of California
SSDA	Small School Districts' Association
START	State Teachers' Automation Redesign Team
STRS	State Teachers' Retirement System
TFD	Teachers for Fair Disability
TRB	Teachers' Retirement Board
TRF	Teachers' Retirement Fund
TRL	Teachers' Retirement Law
USERRA	Uniformed Services Employment and Reemployment Rights Act
UTLA	United Teachers Los Angeles

STANDING COMMITTEES OF THE ASSEMBLY/SENATE

Assembly PER&SS	Assembly Public Employees Retirement and Social Security
Senate IR	Senate Industrial Relations